

In Re MEDICIS PHARMACEUTICAL CORP. SECURITIES LITIGATION
Master File No. CV-08-01821-PHX-GMS

Lodged: Proposed

**MEMORANDUM OF POINTS AND AUTHORITIES IN OPPOSITION TO
DEFENDANTS MEDICIS PHARMACEUTICAL CORPORATION AND ERNST
& YOUNG'S MOTIONS TO DISMISS THE SECOND CONSOLIDATED
AMENDED COMPLAINT**

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UNITED STATES DISTRICT COURT
DISTRICT OF ARIZONA

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CORP. SECURITIES LITIGATION)

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TABLE OF CONTENTS

PRELIMINARY STATEMENT	1
BACKGROUND	3
Defendant’s Application of Footnote 3 to SFAS 48 Was Not Supported By the Requirements for its Application or by the Language of SFAS 48	3
Medicis's Customers Were Not "Ultimate Customers" Under SFAS 48	4
Medicis’ New Product Was Not Of The Same Quality, Kind and Price	5
A Prominent Authority On Accounting Stated That Medicis and E&Y’s Application of Footnote 3 to SFAS 48 Was “Clearly Inappropriate”	6
Virtually All Of Medicis’ Competitors Properly Complied With SFAS 48	7
Medicis Did Not Disclose To Investors That It Was Applying Footnote 3	8
Impact of the Company’s Accounting Improprieties	10
Testimony of Confidential Witnesses	11
Medicis’ Channel Stuffing Practices During The Class Period	12
Medicis Employees Knew That The Company’s Accounting Was Improper	12
Medicis & E&Y’s Knowledge of The Reserve Manipulations	14
ARGUMENT	17
THE SAC ADEQUATELY ALLEGES SCIENTER	17
A. Standards for Pleading <i>Scienter</i> Under Section 10(b) of the Exchange Act	17
B. The SAC Satisfies the Ninth Circuit’s Analysis for <i>Scienter</i> and the Holistic Approach Mandated By the Supreme Court	19
1. The SAC Contains Numerous Additional <i>Scienter</i> Allegations Against Defendants	19
a. Dr. Ronen’s Testimony Supports Plaintiffs’	

1	Allegations	
2	Regarding Defendants Baseless Application	
3	of Footnote 3 to SFAS	20
4	b. The SAC Alleges Defendants Misled Investors	
5	Regarding Accounting Practices	21
6	c. The SAC Contains Allegations Regarding Defendants’	
7	Motives For Manipulating Medicis’ Revenues And	
8	Working Capital	23
9	d. The SAC Provides Additional Details By Confidential	
10	Witnesses Regarding the Company’s Accounting	
11	Manipulations	24
12	C. Application of the <i>South Ferry</i> Core Operations Doctrine	
13	Further Supports the Denial of Defendants’ Motion to Dismiss	26
14	1. Actual Knowledge Analysis	27
15	2. The Absurdity Analysis	29
16	3. The Holistic Analysis	31
17	D. The Allegations Support Ernst & Young’s Scierter	32
18	E. The Amended Complaint Adequately Alleges Section	
19	20(a) Liability.....	34
20	CONCLUSION	34

TABLE OF AUTHORITIES

CASES

<i>In re Apollo Group Inc. Sec. Litigation</i> , 395 F. Supp. 2d 906 (D. Ariz. 2005).....	9, 23
<i>Backe v. Novatel Wireless, Inc.</i> , 642 F. Supp. 2d 1169 (S.D. Cal. 2009).....	25, 31
<i>Berson v. Applied Signal Technology, Inc.</i> , 527 F.3d 982 (9th Cir. 2008).....	29
<i>Brody v. Transitional Hospitals Corp.</i> , 280 F.3d 997 (9th Cir. 2002), cited by defendants	23
<i>Chill v. General Electric Co.</i> , 101 F.3d 263 (2d Cir. 1996).....	34
<i>In re Cirrus Logic Sec. Litigation</i> , 946 F. Supp. 1446 (N.D. Cal. 1996)	1
<i>In re Countrywide Finance Corp. Sec. Litigation</i> , 588 F. Supp. 2d 1132 (C.D. Cal. 2008).....	29, 33
<i>DSAM Global Value Fund v. Altris Software, Inc.</i> , 288 F.3d 385 (9th Cir. 2002).....	33
<i>In re Daou System, Inc.</i> , 411 F.3d 1006 (9th Cir. 2005).....	27
<i>Demarco v. Depotech Corp.</i> , 149 F. Supp. 2d 1212 (S.D. Cal. 2001).....	21
<i>Ernst & Ernst v. Hockfelder</i> , 425 U.S. 185 (1976)	17
<i>Fin. Acquisition Ptnrs. v. Blackwell</i> , 440 F.3d 278 (5th Cir. Tex. 2006)	21
<i>Freedman v. Louisiana-Pacific Corp.</i> , 922 F. Supp. 377 (D. Or. 1996).....	23

1	<i>Glazer Capital Mgmt LP v. Magistri,</i>	
2	549 F.3d 736 (9th Cir. 2008).....	15
3	<i>Helwig v. Vencor, Inc.,</i>	
4	251 F.3d 540 (6th Cir. 2001).....	23
5	<i>Institutional Investors Group v. Avaya, Inc.,</i>	
6	564 F.3d 242 (3d Cir. 2009).....	18, 28, 30
7	<i>Makor Issues & Rights, Ltd., v. Tellabs Inc.,</i>	
8	513 F.3d 702 (7th Cir. 2008).....	15
9	<i>Novak v. Kasaks,</i> 216 F.3d 300 (2d Cir. 2000)	7
10	<i>Nursing Home Pension Fund, Local 144 v. Oracle Corp.,</i>	
11	380 F.3d 1226 (9th Cir. 2004).....	7, 20, 28
12	<i>In re Read-Rite Corp. Securities Litigation,</i>	
13	335 F.3d 843 (9th Cir.2003).....	19
14	<i>Reiger v. Price Waterhouse Coopers, LLP,</i>	
15	117 F. Supp. 2d 1003 (S.D. Cal. 2000), <i>aff'd sub. nom</i>	33
16	<i>RxUSA Wholesale, Inc. v. HHS,</i>	
17	467 F. Supp. 2d 285 (E.D.N.Y. 2006).....	5
18	<i>Shahzad v. H.J. Meyers & Co.,</i>	
19	1997 U.S. Dist. LEXIS 1128 (S.D.N.Y. Feb. 4, 1997)	24
20	<i>In re Silicon Graphics Sec. Litigation,</i>	
21	183 F.3d 970 (9th Cir. 1999).....	19, 26
22	<i>In re Silicon Storage Technology, Inc. Sec. Litigation,</i>	
23	2007 U.S. Dist. LEXIS 21953 (N.D. Cal. Mar. 9, 2007)	21
24	<i>South Ferry LP, Number2 v. Killinger,</i>	
25	542 F.3d 776 (9th Cir. 2008).....	18, 19, 26, 27, 29, 31
26	<i>South Ferry LP #2,</i>	
27	2009 U.S. Dist. LEXIS 91174 (W.D. Wa. Oct. 1, 2009).....	26, 28, 31
28		

1 *Teamsters Local 617 Pension & Welfare Funds v. Apollo Group, Inc.*,
2 633 F. Supp. 2d 763 (D. Ariz. 2009)..... 19, 31
3
4 *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*,
5 551 U.S. 308 (2007) 2, 15, 17, 18, 19, 27, 33
6
7 *In re Vantive Corp. Securities Litigation*,
8 283 F.3d 1079 (9th Cir. 2002)..... 19, 27
9
10 *In re Wash. Mutual Inc. Sec. Litigation*,
11 2009 U.S. Dist. LEXIS 99727 (W.D. Wash. Oct. 27, 2009) 7, 20, 29
12
13 *In re Zucco Partners, LLC v. Digimarc Corp.*,
14 2009 U.S. App. LEXIS 7025 (9th Cir. Feb. 10, 2009) 18
15

16 **STATUTES**

17 Fed. R. Civ. P. 9(b)..... 2, 17
18
19 Food and Drug Administration ("FDA") 21 C.F.R. § 205.5, cited by
20 Defendant E&Y 6
21
22 21 U.S.C. § 331, *et seq* 5
23
24
25
26
27
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Preliminary Statement

The Second Amended Complaint (the “SAC”)¹ alleges that use of the exclusion provided in footnote 3 of Statement of Financial Accounting Standards No. 48 (“SFAS 48”) by Medicis Pharmaceutical Corporation (“Medicis”) and Ernst & Young LLP (“E&Y”) used for short dated and expired products was “clearly inappropriate.” The exclusion, by its own terms, can only be applied for product sold to “ultimate customers.” Medicis’s customers are wholesalers, which remove them from the class of customers for which footnote 3 may be applicable, and the products that defendants were applying the exclusion to were not of the “same quality, kind or price.” In support of plaintiffs’ claims, the SAC directly quotes a leading expert in the field of accounting, Dr. Joshua Ronen. Dr. Ronen’s assessment supports plaintiffs’ allegation that Medicis’s and E&Y’s accounting for short dated and expired products was not a reasonable interpretation under Generally Accepted Accounting Practices (“GAAP”). As Dr. Ronen stated, “neither Medicis nor Ernst & Young had a sound basis to conclude that the exclusion of footnote 3 was applicable to Medicis’ transactions.” ¶ 44.

Medicis and E&Y would have this Court hold that any violation of GAAP can never support *scienter* because GAAP requires an exercise of judgment. The case law cited by the defendants, however, says that GAAP “tolerates a range of reasonable treatments.” *In re Cirrus Logic Sec. Litig.*, 946 F. Supp. 1446, 1457 (N.D. Cal. 1996). Here, the treatment that Medicis and E&Y used was not *reasonable*. It was “clearly inappropriate” under the very language of footnote 3 of SFAS 48. This is plaintiffs’ allegation, and Dr. Ronen’s assessment supports that allegation. To hold that any GAAP violation is immune to inferences of *scienter*, as defendants suggest, would remove false financial statements from the range of actionable statements under the securities laws. There is nothing in the case law or legislative history which supports such a proposition,

¹ Citations to the SAC are denoted by ¶ ____.

1 and here, where the application is wholly contrary to the language of the exclusion under
2 footnote 3, even the case law cited by defendants supports sustaining the SAC.

3 Indeed, plaintiffs' allegations are sufficient under the pleading standards of the
4 Private Securities Litigation Reform Act of 1995 (the "PSLRA") and Fed. R. Civ. P. 9(b)
5 requiring specificity or particularization. Medicis and E&Y, however, do not argue that
6 the allegations lack specificity, but instead argue a competing interpretation of the facts.
7 The Supreme Court has held that the task of the Court at this stage of the litigation is not
8 to decide the merits of the competing facts, but to consider whether plaintiffs' allegations
9 are as "cogent and at least as compelling as any opposing inference once could draw from
10 the facts alleged." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 314 (2007).
11 Here, nothing that Medicis and E&Y have proffered renders their interpretation more
12 compelling than the inference of *scienter* that plaintiffs' propound.

13
14 Moreover, the SAC alleges additional claims that Medicis and E&Y misled
15 investors about how the Company was actually accounting for short dated and expired
16 products, and further support defendants' inference of *scienter* by way of the testimony of
17 confidential witnesses and allegations of defendants' reasons or incentive to control the
18 timing of Medicis's revenue recognition. Read holistically, as the Supreme Court
19 requires, the totality of the allegations support the inference that defendants intentionally
20 or recklessly made the material misrepresentations and omissions alleged in the SAC.

21 This is the fundamental issue before the Court. Defendants have not moved to
22 dismiss by challenging that plaintiffs did not allege with adequate particularity that
23 Medicis, the Individual Defendants, and E&Y made material misrepresentations and
24 omissions which artificially inflated the price of Medicis common stock, and that upon
25 the disclosure of those material misrepresentations and omissions the price of Medicis
26 common stock declined causing injury to the Class. The only issue before the Court is
27 whether the SAC adequately pleads an inference of *scienter*.
28

Background

Medicis is a specialty pharmaceutical company that markets perishable dermatological, aesthetic and podiatric drugs, *i.e.*, pharmaceuticals with limited shelf life, to wholesale distributors, who then sell its products to customers such as retail pharmacies and dermatologists. ¶ 25-27, 41. Manufacturing perishable products entails the inherent risk that unsold products will be returned as the date of expiration nears. Thus, pursuant to SFAS 48, Medicis was required to estimate likely returns and to exclude that portion from revenue recognized on the sale of products to wholesalers, and to book reserves for the expected sales returns. ¶ 3. Moreover, the Company was required to accrue the portion of revenues reduced as a result of anticipated returns from its accounts receivables, thereby decreasing its working capital, a metric provided by the Company to give investors a view of its ability to meet its capital requirements as an ongoing concern.

Medicis' business model was predicated on its ability to stuff its wholesale customer channels with unneeded prescription drugs, which could be exchanged by customers once the product was at or near expiration. ¶ 40. This practice allowed the Company to manage its earnings *i.e.*, if the demand for its prescription drugs was too low in a given period, it could simply push unneeded inventory on to its wholesale customers which could be returned at a later date once the product expired—and Medicis could recognize the revenues immediately. *Id.*

Defendant's Application of Footnote 3 to SFAS 48 Was Not Supported By the Requirements for its Application or by the Language of SFAS 48

The express dictates of SFAS 48, however, presented a threat to this business model. Statement of Financial Accounting Standards No. 5, enacted in 1975, requires companies to account for loss contingencies as a charge to income if the contingency is probable or estimable. ¶ 38. SFAS No. 48, which was adopted nearly three decades ago, specifically provides that "sales revenue and cost of sales reported in the income

statement shall be reduced to reflect estimated returns.” *Id.* There is no room for disagreement as to the application of this principle. Companies are required to deduct from their gross sales the estimated returns expected from such sales. ¶ 39. By way of example, if Company X had \$100 million in gross sales in a given period, but anticipated that 20% of the products it had sold would be returned, it would only be able to record \$80 million in sales for that year. *Id.* Moreover, the Company would need to accrue \$20 million as a reserve for accounts receivables, thereby decreasing its working capital by \$20 million.

This simple accounting rule, however, threatened to upend the Company’s long standing channel stuffing scheme. If the Company heeded the express dictates of SFAS 48, it would be required to establish a reserve for all of the excess product stuffed into the channel that would be returned or replaced. ¶ 40. Thus, if anticipated returns had to be deducted immediately from revenues, there would be no benefit to be derived from stuffing the distribution channel, and the Company would lose a key tool in its arsenal for manipulating revenues and working capital. *Id.*

As a result, the Company sought an end run around the simple dictates of SFAS 48 by exploiting an exclusion provided in footnote 3 of the provision, which states that “[e]xchanges by *ultimate* customers of one item for another of the *same, kind quality and price* (for example, one color or size for another) are not considered returns for purposes of this statement.” ¶ 41. In utilizing this exclusion, the Company improperly treated its returns as warranty exchanges, and thereby artificially inflated its revenues by utilizing a substantially lower replacement cost of anticipated returns, rather than gross sales. ¶ 42.

Medicis’ Customers Were Not “Ultimate Customers” Under SFAS 48

The exemption provided by footnote 3, however, was wholly inapplicable to Medicis’ expired product returns. First, Medicis’ customers are not “ultimate customers.” As Medicis admitted in Form 10-K’s filed with the SEC, the Company’s

customers were wholesalers such as Quality King and AmerisourceBergen who sold the products to retail pharmacies and dermatologists. It was the wholesalers, pharmacies and dermatologists that filled prescriptions thereby selling to the “ultimate customer,” *i.e.*, patients. ¶¶ 7, 41. Indeed, in the six briefs filed by the various defendants to date, not one has proffered *any* rational or reasonable basis to explain how the exclusion to SFAS 48 could be applicable to sales by Medicis to its customers – wholesalers. None has been proffered because there is none. The facts are uncontroverted and beyond peradventure that Medicis did not sell its product to “ultimate customers” under SFAS 48. Accordingly, there is no basis, much less a reasonable one, to invoke the exclusion under footnote 3 to SFAS 48.

Medicis’ New Product Was Not Of The Same Quality, Kind and Price

Furthermore, the exclusion provided by footnote 3 of SFAS 48 can only apply to product that is of the “same quality, kind and price.” Medicis’s unsalable, expired prescription drugs were not of the “same quality, kind and price” as drugs that were offered as a replacement. Indeed, the safe and efficacious replacement drugs were at least fifteen months from expiration. ¶ 42. Aside from violating all notions of common sense, Medicis and E&Y’s position was belied by the fact that the Company destroyed such expired products upon receipt from its customers, or sold them at a steep discount to charities. ¶¶ 43, 6.

In addition to Medicis’ own practices debunking the ridiculous notion that expired pharmaceuticals are of the “same quality kind, and price” as unexpired products, federal statute reinforces the unreasonableness of defendants position because expired pharmaceutical products cannot be resold. *See* Prescription Drug Manufacturing Act, 21. U.S.C. 331, *et seq.* (Public Law 100-293); *RxUSA Wholesale, Inc. v. HHS*, 467 F. Supp. 2d 285, 293 (E.D.N.Y. 2006) (“[t]he object of the bill introduced into the U.S. House of Representatives and the Senate, which eventually became the PDMA, was to assure safe and effective distribution of prescription drugs and to minimize risks to consumers from

1 taking counterfeit, adulterated sub-potent or expired drugs. *See The Prescription Drug*
 2 *Marketing Act Report to Congress June 2001.*”). Indeed, Food and Drug Administration
 3 (“FDA”) 21 C.F.R. § 205.5, cited by Defendant E&Y, specifically provides that
 4 “[p]rescription drugs that are outdated . . . shall be quarantined and physically separated
 5 from other prescription drugs until they are destroyed or returned to their supplier.” Thus
 6 there was and is simply no good faith or reasonable basis for Medicis to invoke the
 7 exclusion under footnote 3 of SFAS 48 by deeming its unsalable, outdated prescription
 8 drugs as the “same, quality, kind and price” as drugs that were 12-15 months from
 9 expiration.

10
 11 **A Prominent Authority On Accounting Stated That Medicis and E&Y’s**
 12 **Application of Footnote 3 to SFAS 48 Was “Clearly Inappropriate”**

13 The lack of any reasonable basis on the part of Medicis and E&Y to exploit
 14 footnote 3 of SFAS 48 is further supported by Dr. Joshua Ronen, an eminent Professor
 15 of Accounting and former Peat Marwick Faculty Fellow at New York University’s
 16 Leonard N. Stern School of Business. Dr. Ronen confirmed that the Company had no
 17 basis to employ the exclusion provided by footnote 3 of SFAS 48 ¶ 44. Dr. Ronen
 18 reviewed the Company’s Form 10-K’s as well as the Medicis press releases and made the
 19 following assessment:

20 In reviewing the Company’s statements regarding its accounting for
 21 return reserves for short dated and expired product during the Class Period,
 22 it is my opinion that the only correct accounting treatment for the product
 23 exchange is the one governed by SFAS 48. Under this standard, the
 exchanges should have been accounted for as a reduction in revenue and
 cost of sales to reflect estimated returns.

24 *****

25 Treatment of the exchange transactions as returns under the
 26 exclusion provided in footnote 3 of SFAS 48 “exchanges by ultimate
 customers of one item for another of the same kind, quality and price” is
 27 ***clearly inappropriate***: Neither the wholesale customers of Medicis are
 28 “ultimate customers” nor is the quality of the products subject to exchanges
 the same “quality kind or price.” Hence, ***neither Medicis nor Ernst &
 Young had a sound basis to conclude that the exclusion of footnote 3 was
 applicable to Medicis’s transactions.***

1 *Id.* (emphasis added).

2 Plaintiff's allegations in the SAC citing Dr. Ronen's expert assessment at the
3 pleadings stage is wholly supported by applicable case law. *Nursing Home Pension*
4 *Fund, Local 144 v. Oracle Corp.*, 380 F.3d 1226 (9th Cir. 2004) (citing *Novak v. Kasaks*,
5 216 F.3d 300, 314 (2d Cir. 2000); *In re Wash. Mut. Inc. Sec. Litig.*, 2009 U.S. Dist.
6 LEXIS 99727, at *24 (W.D. Wash. Oct. 27, 2009) (finding that plaintiffs "have also
7 provided expert data analysis reinforcing their claim that WaMu's appraisal process was
8 corrupt").

9
10 **Virtually All Of Medicis' Competitors Properly Complied With SFAS 48**

11 In stark contrast to Medicis, virtually all of the Company's competitors properly
12 accounted for the exchange of expired products during the Class Period. ¶ 45. For
13 example, Johnson & Johnson, one of Medicis' main competitors, stated in its 10-K for
14 the period ending December 31, 2007, that "[p]rovisions for certain rebates, sales
15 incentives, trade promotions, coupons product returns and discounts to customers are
16 accounted for as reductions in sales in the same period that related sales are recorded."
17 (Johnson & Johnson, 10K filed dated 2/26/08, page 44 (emphasis added). ¶ 46. Teva
18 Pharmaceutical Industries, Ltd. ("Teva"), one of the largest prescription drug
19 manufacturers in the world "reco[r]ded a reserve for estimated sales returns in accordance
20 with the provision of [S]FAS 48. 'Revenue Recognition When Right of Return Exists'
21 (Teva Pharmaceutical Industries 20-F dated 2/28/08, page 67). *Id.*

22 Notably, Allergen, Inc., *a company audited by E&Y*, made provisions for returns
23 "*based upon historical patterns of products returned matched against the sales from*
24 *which they originated.*" (Allergen, Inc. 10-K dated 2/28/08, page 45) (emphasis added).
25 *Id.* Other examples abound, such as Impax Laboratories, Inc. ("Impax"), KV
26 Pharmaceutical Company ("KV"), and others.

27 That defendants can point to two pharmaceutical companies which did not
28 properly apply SFAS 48 does not support their proposition that failure to properly apply

footnote 3 to SFAS 48 was reasonable. Moreover, unlike Medicis, Questcor Pharmaceuticals, Inc., had only a *de minimis* amount of \$11,000 in returns to customers, who were not ultimate users under SFAS 48. *See* ¶ 49. In addition, Questcor changed its policy and properly accounted for returns post-May 31, 2004. *Id.* Next, unlike Medicis, Heska Corporation advised investors that it had “record[ed] an accrual for the estimated cost of replacing the expired product expected to be returned in the future” ¶ 50. Thus, while Heska was in violation of SFAS 48, it did not materially misrepresent to investors its accounting for expired products as Medicis did. More importantly, that another accountant violates a GAAP standard is not a reasonable basis for Medicis’ and E&Y’s violation. Were that the case, then any violation of GAAP by one company or auditing firm would be a basis for every other company or auditing firm to claim that it was reasonable for them to violate GAAP. Such a proposition would defeat individual responsibility under the law, and render GAAP meaningless. There is nothing in American jurisprudence that would support such a proposition under the rule of law.

Medicis Did Not Disclose To Investors That It Was Applying Footnote 3

Significantly, Medicis never disclosed to investors that it was exploiting an exclusion to SFAS 48 based upon the tenuous contention that its unsalable, expired drugs, were of the same “quality, kind and price” as new drugs. Moreover, the Company never alerted investors that it was reserving for returns based upon replacement costs, rather than as a deduction from gross sales. *Id.*

Indeed, Medicis’ disclosures during the Class Period were purposefully crafted to lead investors to believe that it was reserving for returns by reducing gross sales in accordance with SFAS 48. *Id.* The Company’s 10-K throughout the Class Period made the following statements regarding its return reserve policy, which it acknowledged was one of its “critical” accounting policies:

programs are established as a reduction of product sales revenues at the time such revenues are recognized. These deductions from gross revenue are established by the Company’s management as its best estimate at the

time of sale based on historical experience adjusted to reflect known changes in the factors that impact such reserves, including but not limited to, prescription data, industry trends, competitive developments and estimated inventory in the distribution channel.

Provisions for estimates for product returns and exchanges, sales discounts, chargebacks, managed care and Medicaid rebates and consumer rebate and loyalty programs are established as a reduction of product sales revenues at the time such revenues are recognized.

¶ 51. (emphasis supplied).

Nothing in these statements comes close to suggesting that Medicis was utilizing an exclusion to SFAS 48 when reserving for returns. ¶ 51. Moreover, Medicis made no mention of the fact that it was reserving for returns at replacement costs, rather than as a reduction from gross revenues. ¶ 52. At bare minimum, once Medicis spoke regarding its return reserve policies, it had a duty to fully inform the investing public of its deviant accounting policies. *In re Apollo Group Inc. Sec. Litig.*, 395 F. Supp. 2d 906, 919-20 (D. Ariz. 2005) (“[a]lternatively, even if Defendants were correct in their assertion that they had no duty to disclose the report when it was issued, the Court finds that at the point Defendants chose to speak about the DOE investigation, they had a duty to speak fully and truthfully and such full disclosure would have included the negative DOE Report”) (citations omitted).

However, far from “fully and truthfully” disclosing its return reserve policies, the Company intentionally misled the public regarding the nature of its reserves. As Dr. Ronen noted, “a reasonable accounting professional reading Medicis’ statements regarding its policies for return reserves would have assumed that the Company was reserving for expired and short dated products in conformity with SFAS 48, and not pursuant to the exclusion set forth in footnote 3. There is nothing in the Company’s 10-K that would have led a reasonable accounting professional to the conclusion that the Company was reserving for returns based upon replacement costs, rather than deducting anticipated returns from gross sales.” ¶ 52.

1 As a result, Medicis' statements throughout the Class Period regarding its return
2 reserves intentionally or recklessly led investors to believe that the Company was
3 reserving in accordance with SFAS 48, which as the Company later acknowledged, was
4 completely not true. ¶ 53. Moreover, E&Y consistently signed off on these financial
5 statements as conforming to GAAP, even though investors were completely misled
6 regarding the nature of the Company's return reserve policy.

7 **Impact of the Company's Accounting Improprieties**

8 On November 10, 2008, after the market closed, Medicis filed an amended annual
9 report for 2007 on Form 10-K/A and amended quarterly reports for the first two quarters
10 of 2008 on Form 10-Q/A, which materially shifted the Company's reported revenues for
11 the past five years to reflect proper sales return reserve accounting. ¶ 147. The
12 Company's restatement demonstrates how it utilized channel stuffing as a mechanism to
13 manage earnings and portray itself as a company with consistent and reliable growth –
14 which could be counted on to break its previously set financial records. ¶ 148. In fact
15 though, the Company's financial performance was in reality erratic and unreliable.

16 For example, on November 7, 2007, the Company announced revenues of \$120.4
17 million, compared to the prior quarter's revenue of \$108.8 million. Defendant Shacknai,
18 in an effort to artificially boost the Company's stock price, boasted that these figures
19 represented "another record revenue quarter" for Medicis. *Id.* However, the Company's
20 restated revenues for the quarter was only \$110.9 million, *3 million less than the*
21 *Company's restated revenues of \$113 million for the prior quarter. Id.* Thus, contrary to
22 Shacknai's bluster, Medicis was indeed *not* experiencing yet "another revenue record
23 quarter" -- in fact its numbers were weak compared to the prior quarter. *Id.*

24 Similarly, the Company's machinations allowed it to portray itself as a Company
25 with steadily increasing annual revenues. ¶ 149. For example, from 2002 to 2003, the
26 Company reported that its revenues increased from \$212 million to \$247 million, an
27 impressive rise of 16.3%. In reality though, the Company's actual revenues for 2003
28

1 were \$210.3 million, which represented a decline from the prior year's revenues of
2 \$212.8 million.

3 In addition, the Company's faulty accounting materially inflated its reported
4 working capital throughout the Class Period, which was a critical metric analyzed by
5 Wall Street to assess the Company's ability to operate as an ongoing concern and expand
6 its operations. ¶ 152. For example, the Company's reported working capital of \$600.1
7 million for the fiscal year ended June 30, 2005, was inflated by 69.2 million, or 13%.
8 Moreover, the Company's reported working capital of \$356.9 million for the fiscal year
9 ending December 31, 2006 was inflated by \$33.8 million, or 10.4%.

10 As a result, the Company's Class Period accounting manipulations had a material
11 impact on the Company's reported financial results, thereby necessitating a restatement.

12 **Testimony of Confidential Witnesses**

13 The testimony of Confidential Witnesses paints a picture of a Company that
14 consistently stuffed its channel in a gambit to manipulate its revenues, with the tacit
15 approval of E&Y. Confidential Witness 1 ("CW 1") was an accounts receivable senior
16 accountant at Medicis from 2000 to 2006. ¶ 31. CW1 reported to Brian Barley
17 ("Barley"), vice president of accounting, and Defendant Peterson. CW1 was directly
18 involved in calculating reserves under the improper replacement cost methodology. *Id.*
19 CW1 voiced her concerns over this accounting treatment several times to Barley and
20 Defendant Peterson. *Id.* Confidential Witness 2 ("CW2") was a senior accounts
21 receivable coordinator at Medicis during parts of 2008. ¶ 32. CW2 confirmed that
22 Medicis accounted for the exchanges of expired/short-dated products using "zero dollar
23 invoices" that "created a wash on the books." *Id.*

24 Confidential Witness 3 ("CW3") was an accounts receivable team leader at
25 Medicis between 2000 and 2004. ¶ 33. CW3 confirmed that Medicis routinely pressured
26 customers to accept exchanges of returned product instead of credit, which would have to
27 be reflected in a credit memo and booked against revenue. *Id.* Confidential Witness 4

1 (“CW4”) was a senior financial analyst at Medicis in 2005. ¶ 34. CW4 reported to Barley
2 and Defendant Peterson. *Id.* CW4 stated that Medicis was aware that expired and short-
3 dated product could not be treated for accounting purposes as equivalent new product
4 because in 2005 Medicis’ accountants required it to establish a reserve for the expired
5 inventory at its own warehouse. CW4 helped implement that inventory reserve.

6 Confidential Witness 5 (“CW5”) was the head of information technology for
7 Medicis’ finance department from 2001 until 2008, and oversaw the operation of the
8 financial accounting and reporting software used by Medicis. ¶ 35. According to CW5,
9 reserve accounting methodology was “always an issue” at Medicis during his
10 employment, and was a point of contention between auditors and management. *Id.* CW5
11 confirmed that Defendants Peterson and Prygocki were aware of these issues because he
12 was consistently asked to generate reports for the Company’s auditors extracting
13 historical return rates and returns analyses from the Epicor and SAP accounting systems
14 Medicis utilized. *Id.*

15 Confidential Witness 6 (“CW6”) worked at Medicis in the order control
16 department at the Scottsdale, Arizona headquarters from 2003 until 2006. ¶ 36. Between
17 2003 and February 2006, CW6 was an inventory control analyst. *Id.* In February 2006,
18 CW6 was promoted to supervisor of the inventory control department. *Id.* Confidential
19 Witness 7 (“CW7”) was an order control analyst at Medics from June 2005 until
20 November 2007, ¶ 37, and reported to Linda Zelms in the Finance Department.

21
22 **Medicis’ Channel Stuffing Practices During The Class Period**

23 Medicis placed tremendous pressure on its accounting and sales staff to project an
24 image of a Company that was consistently profitable, which could be relied upon to meet
25 analyst expectations. ¶ 54. According to CW1, Medicis’ “executive management was
26 under a lot of pressure to meet expectations on the Street.” *Id.* CW1 relates that “[t]here
27 was an overall expectation on the Company” as a whole that its financial results would be
28 better than the prior quarter. The Company emphasized the importance of having

consecutive quarters without reporting a fiscal loss. *Id.* CW1 recalls the Company celebrating its 20th consecutive quarter without a loss. *Id.*

The Company achieved these consistent results by stuffing the channel, and according to CW5, booking revenues as products sold “just because it went out the door.”

¶ 55. According to CW 5, Medicis monitored the sales from its wholesale customers to end users such as dermatologists by tracking script sales. ¶ 56. Medicis’ order sales reflected product purchases by wholesale distributors. *Id.* Script sales, or script data, however, reflected the number of Medicis products physicians purchased from the Company’s distributors. *Id.* According to CW5, “script sales were never in line with order sales.” For example, the script data might have shown the sale of thirty units of a certain drug sold to physicians, while Medicis’ corresponding order data showed a sale of **400** units to the Company’s wholesale customers. *Id.* CW5 relates that the data showed that Medicis was selling far more product than its wholesale customers were able to resell, and the remaining inventory was lying idle on shelves somewhere. *Id.*

In order to induce its wholesale customers to accept the excess inventory, Medicis allowed for a liberal return policy regarding returned short dated or expired products, including permitting the exchange of such products for fresher product at no cost. ¶ 56. According to CW2, if a customer returned a product, Medicis’ ordering department created a credit memo acknowledging a financial credit. *Id.* However, if the Company was able to convince the customer to exchange or “swap” the product, Medicis reshipped the new product at “zero dollar value”, i.e., at no cost to the customer. Medicis would create a “zero dollar invoice” for the new product being shipped to the customer. *Id.* According to CW2, the zero dollar invoices “created a wash on the books.” *Id.* CW7 confirmed Medicis’ policy of “zero dollar billing” for returns of expired product for fresh product. ¶ 59. According to CW6, approximately 25% of Medicis’ credit returns were “swaps.” *Id.*

Medicis Employees Knew That The Company’s Accounting Was Improper

1 During the Class Period, numerous Medicis personnel realized that the Company's
 2 accounting relating to return reserves was a sham. ¶ 60. CW2 stated that instead of
 3 creating a zero dollar invoice for the fresh product exchanged for the expired product, the
 4 Company should have matched the market value of the new product and credit the
 5 customer accordingly. "If a customer returned a product six months after expiration, but
 6 Medicis' price (for the returned product) had increased or decreased at the time, they are
 7 not acknowledging a price increase or decrease." *Id.* According to CW2, Medicis'
 8 method for return accounting "makes it easy, but not correct." *Id.*

9
 10 While at the Company, CW1 challenged her supervisors that it was not accurate to
 11 account for the swap as an even exchange when the new product was not of the same
 12 value as the returned product, which was expired or soon to be expired. ¶ 61. In CW1's
 13 own words, "is it really accurate to say this is an even exchange when the value of the
 14 product is so different than it was a year ago?" *Id.* CW1 questioned her supervisors as to
 15 whether Medicis should even be recognizing the swaps as revenue because the customers
 16 did not have a real need for the product. ¶ 62. She was told by management, "I don't care
 17 if you agree with it or not" and to "just book" the reserves. *Id.*

18 CW5 related that Medicis booked the "swap" sale as revenue even though "you
 19 know this stuff is going to come back," albeit in another quarter. ¶ 63. According to
 20 CW5, the Company was "inflating sales by booking revenue for product that the
 21 Company knew was going to be returned." *Id.* Medicis "was not reserving for these
 22 potential returns," and the Company "should not have been recognizing revenue in the
 23 first place." *Id.*

24 **Medicis & E&Y's Knowledge of The Reserve Manipulations**

25 CW5 stated that the Company's calculation of reserves was "always an issue" at
 26 Medicis throughout the Class Period. ¶ 63. Medicis' internal auditors repeatedly asked
 27 CW5 to extract data from the Company's Epicor and SAP systems because they had
 28 issues with Medicis' reserve calculations. *Id.* According to CW5, the Company's reserve

1 calculations “[were] always a point of contention from a revenue standpoint” between
2 Medicis’ internal auditors and Barley and Stongstad. ¶ 64. CW5 relates that Defendant
3 Peterson was aware of the dispute between the internal auditors and the Company’s
4 accounting personnel regarding the reserve calculations. *Id.*

5 E&Y was also acutely aware of the inherent difference in accounting treatment for
6 fresh product and short dated or expired product. ¶ 65. According to CW4, in 2005,
7 E&Y recommended that the Company institute a new reserve for inventory that the
8 Company might not be able to sell before expiring or becoming short dated. *Id.* In light
9 of this recommendation, Medicis created an “expiring inventory reserve.”

10 In addition, prior to CW1’s departure, E&Y auditors asked CW1 a number of
11 questions regarding return reserves. ¶ 66. The auditors asked CW1 for reports and
12 evidence of the Company’s reserve methodology and reconciliations. *Id.* CW1, not
13 feeling comfortable with the company’s accounting practices, referred the auditors to
14 Barely and Songstad. *Id.*

15 The application of SFAS 48 is not an esoteric issue under GAAP, and there was no
16 change in direction within the industry during the Class Period or upon the
17 commencement of oversight by the Public Company Accounting Oversight Board (the
18 “PCAOB”). It is beyond peradventure that the application of SFAS 48 was, and is,
19 central to the core business of the Company, and that neither Medicis, the Individual
20 Defendants, nor E&Y can legitimately argue that they were unaware of this “key”
21 accounting treatment regarding the Company’s products. *See Makor Issues & Rights,*
22 *Ltd., v. Tellabs Inc.*, 513 F.3d 702, 711 (7th Cir. 2008); *accord Glazer Capital Mgmt. LP*
23 *v. Magistri*, 549 F.3d 736, 744 (9th Cir. 2008) (citing *Makor* and holding that “in certain
24 circumstances, some form of collective scienter pleading might be appropriate”). Indeed,
25 throughout the Class Period, Medicis acknowledged in its 10-K’s that its return reserve
26 policy was a “critical” accounting issue.
27

28 For instance, as outlined by the *Makor* Court, there could be circumstances in

1 which a company's public statements were so important and so dramatically false that
2 they would create a strong inference that at least "*some* corporate officials knew of the
3 falsity upon publication." *Id.* at 710. Just as Judge Posner noted in *Makor*, it is
4 "exceedingly unlikely" that Medicis, the Individual Defendants, or E&Y were "unaware"
5 of the application of SFAS 48 and the overstatement of revenues on the Company's
6 books associated with the failure to properly account for the return of perishable goods
7 under SFAS 48.

8
9 Moreover, Medicis' senior managers informed the market that they were on top of
10 the Company's returns, and that returns were not negatively impacting the Company's
11 revenues. During conference calls with analysts, defendants Shacknai and Prygocki
12 stated that they closely followed prescription and sales data. ¶ 92. Schacknai went so far
13 as to state falsely in August 2007 that "we weren't booking revenue in advance of future
14 quarters or even our prescription trends. So they're right in line with our prescription
15 trends." ¶ 123. These false statements to analysts relate directly to the accounting for
16 returns in SFAS 48, and analysts' concerns that returns were impacting revenues.

17 In fact, returns are an inherent part and risk of Medicis's business, and Medicis
18 advised the SEC and investors that it monitored returns and its distribution channels,
19 including data from its accounting records in its Form 10-Ks. ¶ 50. The guiding
20 accounting principle for returns under GAAP is SFAS 48, and it is beyond reason to
21 believe that either Medicis, the Individual Defendants or E&Y were not aware of the
22 accounting that the Company was utilizing during the Class Period, which was premised
23 on the obviously unsupportable premise that Medicis' expired drugs were of the "same
24 quality, kind and price" as drugs that were at a minimum 15 months from expiration.

25 By restating the Company's financials, the defendants have admitted they made
26 material misrepresentations in its financial statements during the Class Period. *See*
27 Accounting Principles Bulletin No. 20 ("APB 20"). Moreover, the restatements of
28 Medicis's financial statements during the Class Period, at the direction of E&Y, are proof

that E&Y's Auditors' Reports disseminated with and certifying those false financial statements also contained material misrepresentations. Whether considered individually or holistically, as the Supreme Court has mandated in *Tellabs*, the allegations in the SAC satisfy the heightened pleading standards under the PSLRA and Fed. R. Civ. P. 9(b) with respect to all of the defendants.

ARGUMENT

THE SAC ADEQUATELY ALLEGES SCIENTER

A. Standards for Pleading *Scienter* Under Section 10(b) of the Exchange Act

It is well-established that to adequately allege *scienter* under Section 10(b) of the Exchange Act, a plaintiff is required to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." *Ernst & Ernst v. Hockfelder*, 425 U.S. 185, 194 (1976). More recently, the Supreme Court held that a complaint will survive a motion to dismiss if the inference of *scienter* is "cogent and at least as compelling as any opposing inference one could draw from the facts alleged." *Tellabs*, 551 U.S. at 324. Thus, if the inferences for and against *scienter* are in equipoise, the complaint must be sustained. The *Tellabs* Court went on to caution that "[t]he inference that the defendant acted with *scienter* need not be irrefutable, *i.e.*, of the 'smoking-gun' genre, or even the 'most plausible of competing inferences.'" *Id.* (citations omitted). It further reaffirmed the applicability, in the context of the PSLRA, of the principles that "the court's job is not to scrutinize each allegation in isolation but to assess all the allegations holistically" (*Id.* at 326), and that a court must "accept all factual allegations in the complaint as true." *Id.* at 322.

Accordingly, in determining the cogency of the allegations, district courts are required to "consider the complaint in its entirety, as well as other sources courts ordinarily examine when ruling on Rule 12(b)(6) motions to dismiss, in particular, documents incorporated into the complaint by reference, and matters of which a court may take judicial notice." *Id.* That is, district courts must consider whether "*all* of the

1 facts alleged, taken collectively, give rise to a strong inference of *scienter*, not whether
 2 any individual allegation, scrutinized in isolation, meets that standard.” *Id.* (emphasis in
 3 original). Thus, “[e]ach case will present a different configuration of factual allegations,
 4 and it is the composite picture, not the isolated components, that judges must evaluate in
 5 the last instance.” *Institutional Investors Group v. Avaya, Inc.*, 564 F.3d 242, 272 (3d
 6 Cir. 2009).

7 The “holistic” approach mandated by the Supreme Court has profoundly altered
 8 the way district courts within the Ninth Circuit analyze *scienter* pleadings. In *In re Zucco*
 9 *Partners, LLC v. Digimarc Corp.*, 2009 U.S. App. LEXIS 7025, at *15-*16 (9th Cir. Feb.
 10 10, 2009), the Ninth Circuit noted:

11 Although we have developed a set of rules to analyze different types
 12 of *scienter* allegations, we recognize that *Tellabs* calls into question a
 13 methodology that relies exclusively on a segmented analysis of *scienter*.
 14 We read *Tellabs* to mean that our prior, segmented approach is not
 15 sufficient to dismiss an allegation of *scienter*. Although we have continued
 16 to employ the old standards in determining whether a plaintiff’s allegations
 17 of *scienter* are as cogent or as compelling as an opposing innocent
 18 inference, *see, e.g., Metzler Investment [GMBH v. Corinthian Colleges,*
 19 *Inc.]*, 540 F.3d [1049] at 1065-69 [(9th Cir. 2005)], we must also view the
 20 allegations as a whole. *See South Ferry LP, No.2 v. Killinger*, 542 F.3d
 21 776, 784 (9th Cir. 2008) (“*Tellabs* counsels us to consider the totality of the
 22 circumstances, rather than to develop separately rules of thumb for each
 23 type of *scienter* allegation.”). Thus, following *Tellabs*, we will conduct a
 24 dual inquiry: first, we will determine whether any of the plaintiff’s
 25 allegations, standing alone, are sufficient to create a strong inference of
 26 *scienter*; second, if no individual allegations are sufficient, we will conduct
 27 a “holistic” review of the same allegations to determine whether the
 28 insufficient allegations combine to create a strong inference of intentional
 conduct or deliberate recklessness.

Id. at *17-*18.

26 Moreover, courts have noted that the Ninth Circuit Court of Appeals decision in
 27 *South Ferry LP No.2 v. Killinger*, 542 F.3d 776, 784 (9th Cir. 2008) represents a “seismic
 28 shift in the Circuit’s analysis of securities fraud complaints and significantly lowers the

bar for pleading scienter.” *Teamsters Local 617 Pension & Welfare Funds v. Apollo Group, Inc.*, 633 F. Supp. 2d 763, 788 (D. Ariz. 2009) (quoting 14 No. 11 Andrews Sec. Litig. & Reg. Rep. 2 (Oct 7, 2008) (footnote omitted). Prior to *South Ferry*, the Ninth Circuit was “more stringent” than other Circuits regarding the standard for pleading scienter. *Id.* at *63. In *South Ferry* however, the Ninth Circuit revisited the issue of the “level of detail required under the PSLRA” when pleading scienter, and radically altered its prior holdings for pleading scienter as articulated in *In re Read-Rite Corp. Secs. Litig.*, 335 F.3d 843 (9th Cir. 2003), *In re Vantive Corp. Secs. Litig.*, 283 F.3d 1079, 1084-85 (9th Cir. 2002), and *In re Silicon Graphics, Inc. Sec. Litig.*, 970 F. Supp. 746, 761 (N.D. Cal. 1997). *Id.* 542 F.3d at 784.

Acknowledging that “perhaps” it had been “too demanding and focused too narrowly in dismissing vague, ambiguous or general allegations of scienter out right,” now, post-*Tellabs* cases, the court stated that “*Tellabs* permits a series of less precise allegations to be read together to meet the PSLRA requirements, those prior holdings . . . notwithstanding.” *Id.* Thus, the Ninth Circuit explicitly instructed Courts “to consider the totality of the circumstances, rather than to develop separately rules of thumb for each type of scienter allegation.” *Id.* Taking a holistic approach requires that “federal courts . . . not close their eyes to circumstances that are probative of scienter viewed with a practical and common-sense perspective.” *Id.* It is that very “practical” and “common sense perspective” which mandates the denial of Defendants’ motion to dismiss.

B. The SAC Satisfies the Ninth Circuit’s Analysis for *Scienter* and the Holistic Approach Mandated by the Supreme Court

The allegations in the SAC support a strong inference of fraud against each of the defendants, regardless of whether the Court applies the individual analysis utilized by the Ninth Circuit prior to *Tellabs*, or the holistic analysis mandated by the Supreme Court in *Tellabs*.

1. The SAC Contains Numerous Additional Scienter Allegations Against Defendants

Contrary to Defendants' assertions, the SAC is replete with numerous additional allegations which were not pled in the first Amended Consolidated Class Action Complaint that further buttress plaintiffs' *scienter* allegations.

a. Dr. Ronen's Testimony Supports Plaintiffs' Allegations Regarding Defendants' Baseless Application of Footnote 3 to SFAS 48

In the December 1, 2009 Order dismissing Plaintiff's Amended Complaint, ("December 1, 2009 Order"), the Court credited Defendants' contention that SFAS 48 was subject to varying interpretations, and that Defendants' utilization of footnote 3 of the provision was merely an "aggressive" interpretation of the provision. Order at 14. Contrary to defendants' attempt to soft pedal their wrongdoing, the SAC alleges that their exploitation of footnote 3 was beyond the range of reasonable accounting, and not merely on the "aggressive" side. As Dr. Ronen noted, Defendant's application of footnote 3 was "clearly inappropriate" and "neither Medicis or Ernst & Young had a sound basis to conclude that exclusion of footnote 3 was applicable to Medicis' transactions." ¶ 44. Indeed, Dr. Ronen states that "the only correct accounting treatment for the product exchange (encountered by Medicis) is the one governed by SFAS 48." *Id.* That is so, because as pled in the SAC, exchanges of expired, unsalable prescription drugs are not of the "same quality, kind and price" as fresher drugs, and that wholesale customers of Medicis are not "ultimate customers" of the Company. *Id.*

Contrary to defendants' representations, incorporating expert testimony at the pleading stage has been upheld by the Ninth Circuit, *see Nursing Home*, 380 F. 3d at 1233, and district courts within the Ninth Circuit. *See Wash. Mut.*, 2009 U.S. Dist. LEXIS 99727, at * 24. Indeed, in *Wash. Mut.*, the district court relied on expert testimony to buttress allegations that Washington Mutual Bank's ("WaMu") "appraisal process was corrupt" and that the Company had a much higher loan to income ratio than its peers which "confirms that the deterioration in the underwriting standards in WaMu was nationwide in scope." *Id.* at *27.

The cases cited by Defendants do not hold otherwise. In *Demarco v. Depotech Corp.*, 149 F. Supp. 2d 1212, 1219 (S.D. Cal. 2001), the court struck an expert's affidavit because it was attached to the pleadings—and not in the complaint itself. In fact, the court denied defendants' motion to strike those portions of the expert's report that were incorporated into the numbered allegations in the complaint. *Id.* at 1222. Similarly, in *Fin. Acquisition Ptnrs. v. Blackwell*, 440 F.3d 278 (5th Cir. Tex. 2006), the expert opinion was contained in an affidavit, and not in the actual pleadings. In *In re Silicon Storage Tech, Inc. Sec. Litig.*, 2007 U.S. Dist. LEXIS 21953, at *31 (N.D. Cal. Mar. 9, 2007), the court disallowed expert testimony which took the form of generic market data. None of these cases stands for the proposition that defendants posit, *i.e.*, that allegations in a complaint may not contain expert testimony.²

b. The SAC Alleges Defendants Misled Investors Regarding Accounting Practices

The SAC also adds allegations regarding Medicis' utter failure to disclose to investors that it was employing a suspect exemption to the express dictates of SFAS 48. Throughout the Class Period, Medicis acknowledged that its accounting for return reserves was a "*critical accounting polic[y] . . . in understanding our financial condition and results of operations.*" ¶ 79 (emphasis added). Yet despite the "critical" nature of the Company's return reserve accounting, it completely failed to disclose to investors that it was reserving for returns by reducing revenues by replacement costs, as opposed to gross sales, despite the express dictates of SFAS 48. Investors would surely have wanted to know that the Company's reserve calculations were based upon the dubious premise that unsalable, expired drugs were of the "same quality, kind and price" as fresher drugs. Moreover, investors would have also wanted to know, and had every right to know, that the Company's reserve calculations were based upon the indefensible

² The SAC also sufficiently states that Ronan's basic credentials as an expert and the basis of his assessment. No more is required. *Nursing Home Pension Fund, Local 144* at 1233.

1 notion that the Company's customers were "ultimate customers," despite the fact that the
 2 Company consistently acknowledged in its 10-K's that its customers were "primarily
 3 large pharmaceutical wholesalers." (Underscore added.) Had investors known these facts,
 4 they would have been on alert that the Company's revenues and working capital were
 5 based upon untenable premises, and risked severe restatement.

6 Instead, Medicis purposefully tailored its disclosures to lead investors to falsely
 7 believe that it was reserving for returns by reducing gross sales in accordance with SFAS
 8 48. Throughout the Class Period, Medicis stated that "provisions for estimates for
 9 product returns and exchanges . . . ***are established as a reduction of product sales***
 10 ***revenues at the time such revenues are recognized.***" ¶ 50. After reviewing the
 11 Company's disclosures regarding its return reserve policy, Dr. Ronen stated: "a
 12 reasonable accounting professional reading Medicis' statements regarding its policies for
 13 return reserves would have assumed that the Company was reserving for expired and
 14 short dated products in conformity with SFAS 48, and not pursuant to the exclusion set
 15 forth in footnote 3. ***There is nothing in the Company's 10-K that would have led a***
 16 ***reasonable accounting professional to the conclusion that the Company was reserving***
 17 ***for returns based upon replacement costs, rather than deducting anticipated returns***
 18 ***from gross sales.***" ¶ 52 (emphasis added).

19
 20 In their memoranda in support of their Motions to Dismiss, the Medicis
 21 Defendants attempt to deflect this glaring misrepresentation by arguing that they had no
 22 duty to disclose the specifics of their accounting practices. Medicis Defendants Motion
 23 to Dismiss ("Medicis MTD"), page 5, footnote 3. First, as confirmed by Dr. Ronen,
 24 Defendants misstatements were more than mere omissions, as they would have led a
 25 "reasonable" accounting professional to believe that the Company was reserving for
 26 returns based upon gross sales. Moreover, even assuming *arguendo* that the alleged
 27 misstatements were merely omissions, given that the Company already made some
 28 disclosure regarding its "critical" return reserve accounting, it was under every obligation

to make such disclosures complete and accurate for investor consumption. *Apollo Group*, 395 F. Supp. 2d at 919-920 (“at the point Defendants chose to speak about the DOE investigation, they had a duty to speak fully and truthfully, and such full disclosure would have included the negative report”); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 561 (6th Cir. 2001) (“even absent a duty to speak, a party who discloses material facts in connection with securities transactions assumes a duty to speak fully and truthfully on those subjects.”); *Freedman v. Louisiana-Pacific Corp.*, 922 F. Supp. 377, 387 (D. Or. 1996).³

c. The SAC Contains Allegations Regarding Defendants’ Motives For Manipulating Medicis’ Revenues And Working Capital

In the December 1, 2009 Order, the court found that the complaint had failed to allege “facts suggesting why a company would deliberately control the timing of the revenue recognition,” Order at 17, and “provid[ed] no reason or incentive for Defendants to intentionally or recklessly control the timing of Medicis’ revenue recognition.” *Id.* The SAC cures these defects by alleging a scheme to manage revenues.

Specifically, the SAC alleges that throughout the Class Period, Medicis touted itself as a pharmaceutical Company of consistent and reliable growth—which could be counted on to continuously break its previously set revenue records. ¶ 148. That image was maintained by the Company’s channel stuffing practices and outright violation of SFAS 48. In short, the Company embarked upon a scheme to push forward revenues in certain quarters in order to maintain an image of consistent and steady growth.

For example, on November 7, 2007, the Company announced revenues of \$120.4 million, compared to the prior quarter’s revenue of \$108M. ¶ 148. In reference to these financial results, Defendant Shacknai, boasted of “another record revenue quarter” for Medicis. However, Medicis’ restated figures demonstrate that the Company’s actual

³ *Brody v. Transitional Hosps. Corp.*, 280 F.3d 997, 1006 (9th Cir. 2002), cited by defendants, is inapposite, as the Ninth Circuit did not hold that a statement made by a company could omit material facts which render that statement misleading.

1 revenue for the period ending September 30, 2007 was only \$110.9M, 3 million less than
 2 the Company's restated revenues of \$113M for the prior quarter. *Id.* Thus, Medicis in
 3 fact did not achieve yet "another revenue record quarter." *Id.*

4 The Company's revenue manipulation scheme extended to its annual financial
 5 reports as well. For example, from 2002 to 2003, the Company reported that its revenues
 6 increased from \$212.M to \$247.52M, an impressive increase of 16.3%. ¶ 149. In reality
 7 though, the Company's actual revenues for 2003 were 210.3M, which represented a
 8 decline from the prior year's revenues of \$212.8M. *Id.* Thus, the Company's restatement
 9 demonstrates that its revenue manipulations were crafted to lead the market to believe its
 10 claims of steady and reliable growth, and thereby inflate the price of the Company's
 11 stock.
 12

13 The SAC also adds further details regarding the Company's manipulation of
 14 working capital—which was reported by Medicis in every period during the Class Period
 15 and is a critical gauge of a company's ability to manage its operations and expand its
 16 business. ¶ 152. *Shahzad v. H.J. Meyers & Co.*, 1997 U.S. Dist. LEXIS 1128, at *8
 17 (S.D.N.Y. Feb. 4, 1997) (denying motion to dismiss where plaintiff alleged that
 18 defendant company had misstated its working capital). For example, the Company's
 19 reported working capital of \$600.1 million for the fiscal year ended June 30, 2005, was
 20 inflated by 69.2 million, or 13%. *Id.* Moreover, the Company's reported working capital
 21 of \$356.9 million for the fiscal year ending December 31, 2006 was inflated by \$33.8
 22 million, or 10.4%. *Id.* Thus, the SAC provides another motive for the Company to
 23 violate the express dictates of SFAS 48—the material inflation of working capital, which
 24 was considered by analysts who followed Medicis.

25 **d. The SAC Provides Additional Details By Confidential Witnesses**
 26 **Regarding the Company's Accounting Manipulations**

27 In the December 1, 2009 Order, the court found the complaint's allegations
 28 provided by the CW's insufficient to support an inference of *scienter* because they lacked

1 supporting detail regarding their personal knowledge of the allegations and because of the
 2 insufficiency of the allegations themselves. The additional CW allegations in the SAC
 3 cure these defects. Specifically, the SAC paints a stark picture of Medicis, with the
 4 imprimatur of E&Y, stuffing its channel in order to manipulate its revenues and
 5 improperly accounting for its return reserves in order to maintain the scheme. *Backe v.*
 6 *Novatel Wireless, Inc.*, 642 F. Supp. 2d 1169, 1186 (S.D. Cal. 2009) (finding that “over-
 7 saturated channels” weighed in support of inference of *scienter*).
 8

9 CW1 relates that Medicis placed tremendous pressure on its accounting and sales
 10 staff to “meet expectations on the Street.” ¶ 54. CW1 recalls that the Company’s
 11 management “celebrated each quarter that they didn’t have a loss.” *Id.* These results
 12 were achieved by stuffing the channel and booking revenues as sold “just because it went
 13 out the door.” ¶ 55. According to CW5, Medicis monitored the sales from its wholesale
 14 customers to end users such as dermatologists by tracking script sales. ¶ 56. While
 15 Medicis’ order sales reflected product purchases by wholesale distributors, script sales, or
 16 script data, reflected the number of Medicis’ products physicians purchased from the
 17 Company’s distributors. *Id.* According to CW 5, order sales outstripped script sales
 18 exponentially—often over ten times the actual script sales.

19 According to CW5, the Company was “inflating sales by booking revenue for
 20 product that the Company knew was going to be returned.” ¶ 63. Medicis “was not
 21 reserving for these potential returns,” and the Company “should not have been
 22 recognizing revenue in the first place.” *Id.*

23 In order to induce its wholesale customers to accept such excess inventory,
 24 Medicis allowed for a liberal return policy. ¶ 58. According to CW2, if a customer
 25 returned a product, Medicis’ ordering department created a credit memo acknowledging
 26 the financial credit. *Id.* However, if the Company was able to convince the customer to
 27 exchange or “swap” the product, Medicis reshipped the new product at “zero dollar
 28 value”, *i.e.*, at no cost to the customer. Medicis would create a “zero dollar invoice” for

1 the new product being shipped to the customer, which “created a wash on the books.”
 2 CW7 confirmed that a swap was booked “as a no dollar sale”. ¶ 59.

3 Several Medicis employees questioned the propriety of the Company’s accounting
 4 for reserves. According to CW2, “If a customer returned a product six months after
 5 expiration, but Medicis’ price (for the returned product) had increased or decreased at the
 6 time, they are not acknowledging a price increase or decrease.” ¶ 60. While at the
 7 Company, CW1 also questioned whether it was really accurate to account for the swap as
 8 an even exchange when the new product was not of the same value as the returned
 9 product -- which was expired or soon to be expired. ¶ 61.

10 These detailed additional allegations, as well as others referenced in the SAC
 11 regarding Medicis’ channel stuffing and faulty accounting, raise an inference that the
 12 Company -- with E&Y’s knowledge -- was stuffing the channel and manipulating its
 13 return reserve calculation in order to meet Wall Street’s financial targets.

14
 15 **C. Application of the *South Ferry* Core Operations Doctrine Further Supports**
 16 **the Denial of Defendants’ Motion to Dismiss**

17 In establishing *scienter*, it is often difficult “to find facts regarding an adversarial
 18 party’s state of mind, given that the only party in full knowledge of those facts is
 19 naturally disinclined to share them.” *South Ferry LP #2*, 2009 U.S. Dist. LEXIS 91174,
 20 at *16 (W.D. Wa. Oct. 1, 2009). As a consequence, Plaintiffs may utilize either direct or
 21 circumstantial evidence to show that defendants knew that their statements were false or
 22 misleading. *In re Silicon Graphics Sec. Litig.*, 183 F.3d 970, 979 (9th Cir. 1999). One
 23 “tool in Plaintiffs arsenal is the ‘core operations’ inference.” *South Ferry LP #2*, 2009
 24 U.S. Dist. LEXIS 91174 at *17. Under the core-operations doctrine, it is reasonable to
 25 conclude that high-ranking corporate officers have knowledge of the critical core
 26 operations of their companies. *Id.*

27 In *South Ferry*, 542 F.3d 776, the Ninth Circuit investigated the interaction of
 28 three cases when considering the permissibility of this inference: *Read Rite*, *Silicon*

1 *Graphics, and Vantive* in light of the then recent Supreme Court decision in *Tellabs*.
2 The Ninth Circuit acknowledged that its three earlier decisions, “read without reference
3 to *Tellabs*, will generally prevent a plaintiff from relying exclusively on the core
4 operations inference to plead scienter under the PSLRA.” 542 F.3d at 784. *Tellabs*,
5 however, changed the landscape for assessing *scienter* under the PSLRA, which led the
6 Ninth Circuit to conclude that its prior jurisprudence was “too demanding and focused
7 too narrowly in dismissing vague, ambiguous or general allegations outright.” Thus in
8 light of *Tellabs*, the *South Ferry* court held that there were three circumstances in which
9 the core operations doctrine could establish *scienter* under the PSLRA. *Id.*

10 The “actual knowledge” analysis finds that pleadings which rest on the core
11 operations theory may satisfy the pleading obligations when there are “detailed and
12 specific allegations about management’s exposure to factual information within the
13 Company,” *i.e.*, facts that indicate that management *actually did* know of the core
14 operations of the subject company.” *Id.* The second application of the core operations
15 doctrine is the “absurdity” analysis. The “absurdity” analysis allows allegations of
16 *scienter* to succeed in those “rare occurrences where the nature of the fact is of such
17 prominence that it would be absurd to suggest that management was without knowledge
18 of the matter.” *Id.* The third is the “holistic” analysis, which supports a strong inference
19 of *scienter* when viewed “with other allegations that, when read together, raise an
20 inference of scienter that is cogent and compelling in light of other explanations.” *Id.* at
21 785. The SAC satisfies all three approaches to the core operations doctrine.

22 **1. Actual Knowledge Analysis**

23 There is no question that Defendants knew of the core operations of Medicis
24 similar to the circumstances in *In re Daou Sys., Inc.*, 411 F.3d 1006, 1022-23 (9th Cir.
25 2005), where defendants were alleged to have been involved “in every detail” of the
26 company and alleged to have actually monitored the data that were the subject of the
27 allegedly false statements, sufficient to plead *scienter* under the PSLRA. Similarly, in
28

1 *Nursing Home*, the court found *scienter* sufficiently pled where the CEO had touted that
2 “all of our information is in one data base. We know exactly how much we have sold
3 around the world.” 380 F.3d at 1231.

4 Here, the SAC makes detailed allegations regarding Defendants’ public statements
5 regarding their knowledge of the Company’s accounting for return reserves and the
6 Company’s flow of product into the pipeline. Throughout the Class Period, Medicis,
7 with E&Y’s sign off, acknowledged that its accounting for return reserves was a “critical
8 accounting policy”. ¶ 79. Moreover, Medicis’ 10-K’s, which were signed by Defendants
9 Shacknai and Prygocki, consistently represented that “*exchanges for expired product are*
10 *established as a reduction of product sales revenues at the time such revenues are*
11 *recognized.*” Further, throughout the Class Period, Defendant Shacknai touted the
12 Company’s quarterly and annual revenues.
13

14 In addition, during an earnings conference call with analysts held on September 1,
15 2005, Defendants Shacknai and Prygocki each represented to analysts that there was no
16 channel stuffing. ¶ 92. In response to an inquiry as to whether there was “unusual
17 stocking” by the distributors, Defendant Shacknai said “No-no unusual stocking that we
18 are aware of. And Mark is in the business of monitoring levels.” *Id.* Defendant
19 Prygocki also answered “. . . our inventory levels in the trade are reasonable. We have
20 said that consistently.” *Id.* Additionally, in an earnings conference call held on August
21 7, 2007, Defendant Prygocki represented that “we weren’t booking revenue in advance of
22 future quarters or even our prescription trends. So they’re right in line with our
23 prescription trends.” ¶ 123. Thus Medicis and Defendants Schacknai and Prygocki
24 repeatedly touted their knowledge of the Company’s return reserve policies, revenues and
25 channel flow. As such, they had “actual knowledge” of the underlying facts which
26 triggered the Company’s restatement. *See South Ferry LP #2*, 2009 U.S. Dist. LEXIS
27 91174 at *29 (holding that *scienter* adequately alleged when Defendant repeatedly told
28 the investing public “I know what I am talking about”); *Institutional Investors*, 564 F.3d

at 270 (holding that the possibility that the CEO “was ignorant is not necessarily exculpatory. Even if he were not aware of the full extent of the unusual discounting . . . he might be culpable as long as what he knew made obvious the risk that his confident, unhedged denials . . . would mislead investors.”); *Washington Mut.*, 2009 U.S. Dist. LEXIS 99727 at *28 (holding the Plaintiff’s allegations raise a strong inference of *scienter* where Defendant’s own statements demonstrate that he was deeply familiar with company’s underwriting guidelines); *In re Countrywide Fin. Corp. Sec. Litig.*, 588 F. Supp. 2d 1132 (C.D. Cal. 2008) (finding inference of *scienter* appropriate for the Chief Operating Officer taking into consideration his job position, duties, and access to corporate reports and information systems).

2. The Absurdity Analysis

The SAC also meets the “absurdity” test set forth by the Ninth Circuit in *South Ferry*. The core operations doctrine may be satisfied “where the nature of the relevant fact is of such prominence that it would be absurd to suggest that management was without knowledge of the matter.” Thus, in *Berson v. Applied Signal Tech., Inc.*, 527 F.3d 982, 989 (9th Cir. 2008), the Ninth Circuit found that core operations allegations were sufficient to plead *scienter* where a corporation had categorized a substantial number of government contracts that were subject to “stop work orders” as “backlog,” or work that the Company had contracted to do, but had yet to perform. *Id.* at 984. Contrary to defendants’ characterizaion, however, “stop work” orders generally terminated the contracts entirely, making them unlikely ever to result in reportable income. *Id.* at 987. As the individual defendants were “directly responsible for [the company’s] day to day operations,” it was “hard to believe” that they would not have known about orders that allegedly halted tens of millions of dollars of the Company’s work.” *Id.*

Here, Defendants Shacknai and Prygocki consistently discussed the Company’s reserve return, revenue recognition and channel flow. Moreover, the significance of SFAS 48, which the Company admitted was a “critical” accounting policy, renders it

1 “absurd” to posit that they were not aware of the proper application of the accounting
2 doctrine. Furthermore, the sheer lack of credibility of the Company’s accounting
3 “misinterpretation” also militates in favor of a strong inference of *scienter*. First, in order
4 to trigger the exemption provided by footnote 3 of SFAS 48, the Company had to deem
5 its customers “ultimate customers,” even though the Company’s own 10-K’s and public
6 filings consistently recognized that their customers were wholesalers, who in turn sold
7 products to retailers and end customers. ¶¶ 7, 41. Indeed, in the six briefs collectively
8 filed by defendants to date, *they have not proffered any explanation whatsoever for*
9 *deeming its wholesale customers “ultimate customers.”*

10
11 Moreover, Medicis’ treatment of expired, unsalable drugs as “of the same quality,
12 kind and price” as drugs at least 12-15 months from expiration is facially absurd. That
13 contention is directly contradicted by the testimony of CW1 and CW5 that such expired
14 or nearly expired products were destroyed because “they had no value.” ¶ 43.
15 Defendants attempt to skirt this glaring misrepresentation by arguing that they were
16 merely accounting for returns in a manner that reflected the economic reality of the
17 exchange by reserving for replacement costs. Medicis Mem., at 5. However, regardless of
18 Defendants’ misguided conception of “economic reality,” Medicis was only permitted to
19 reserve based upon replacement costs if it met the explicit requirements of footnote 3. In
20 all of their bluster, Defendants have failed to proffer any evidence that it satisfied these
21 dictates. Similarly, E&Y’s contention that it was accounting for exchanges rather than
22 returns is mere sophistry. E&Y Mem. at 5. Medicis’ returns would only qualify as
23 “exchanges” if it met the direct strictures of footnote 3 of SFAS 48. That they did not,
24 means that such returns were indeed “returns” under SFAS 48 and therefore required the
25 Company to reserve based upon gross sales -- not replacement costs.

26
27 Thus, it is absurd to suggest that Defendants Shacknai and Prygocki and E&Y
28 were unaware of the violations of SFAS 48. *See Institutional Investors*, 564 F.3d at 272
 (“the centrality of operating margins to the ‘Avaya story,’ the magnitude and

pervasiveness of the alleged discounting, and the proximity of the March statements to the end of the quarter . . . all diminish the plausibility of innocent explanations” for misstatements”).

3. The Holistic Analysis

Under the holistic analysis, core operations allegations “may be coupled in any form along allegations that, when read together, raise an inference of *scienter* that is cogent and compelling in light of other explanations.” *South Ferry*, 542 F.3d at 785. Thus, “the core operations inference can be one relevant part of a complaint that raises a strong inference of *scienter*.” *Id.* “Allegations that rely on the core operations inference are among the allegations that may be considered in the complete PSLRA analysis.” *Id.* Thus the core operations can be a plus factor, “adding weight to other allegations and circumstances and giving rise to the necessary level of particularity.” *Id.*

In *South Ferry LP #2*, 2009 U.S. Dist. LEXIS 91174 at *36, the district court found that under the holistic analysis articulated by the Ninth Circuit, confidential witness statements, the CEO’s prominent position within the Company, and repeated representations that WaMu was confident about its risk management combined with core operations allegations sufficed to uphold the complaint at the motion to dismiss stage. In *Backe*, 642 F. Supp. 2d at 1185-86 the Court held that core operations allegations, combined with allegations of channel stuffing, manipulation of revenues, allegations of pushing sales at end of quarter, and restatement of financials combined to sufficiently plead *scienter* under the PSLRA. *See also, Teamsters Local 617*, 633 F. Supp. 2d at 806 (holding that allegations of responsibility for stock option grants coupled with allegations of receipt of backdated options, false Sarbanes-Oxley (“SOX”) certifications, falsely certified 10-K’s, and misstatement of financial reports adequately pleaded *scienter*).

Here, the detailed allegations of the SAC regarding the centrality of return reserve accounting to the Company’s operations, coupled with: 1) numerous CW accounts of the Company’s channel stuffing and accounting manipulations in order to manage revenues

(¶¶ 54-66); 2) Dr. Ronen's assessment regarding the Company's faulty accounting practices (¶¶ 44, 50); 3) allegations regarding the accounting practices and/or disclosures of Medicis' competitors (¶¶ 45-49); Medicis' failure to disclose its non-compliance with SFAS 48 (¶¶ 50-53); and 5) Medicis' violation of GAAP for several consecutive years culminating in a restatement of its reported revenues and working capital, in the aggregate, raise a cogent and compelling inference of *scienter*.

D. The Allegations Support Ernst & Young's Scienter

E&Y willingly allowed Medicis to utilize the exclusion provided by footnote 3 of SFAS for several years despite the fact that there was no reasonable basis to support the use of this exclusion. Moreover, E&Y allowed Medicis to intentionally mislead its investors as to its accounting for return reserves by stating throughout the Class Period that its reserves "*were established as a reduction of product sales revenues at the time such revenues are recognized,*" even though the Company was reducing revenues by the far less substantial replacement costs. ¶ 50. Further indicative of E&Y's *scienter* is the fact that its own client, Allergen, Inc., properly accounted for its return reserves under SFAS 48. ¶ 46.

Moreover, CW4 stated that E&Y specifically discussed with the Company the accounting problems triggered by inventory that became expired or short-dated. ¶ 65. Additionally, prior to CW1's departure, E&Y asked CW1 for reports and evidence of the Company's reserve methodology and reconciliations. ¶ 66. CW1, not feeling comfortable with the Company's accounting practices, deferred E&Y to Barley and Songstad. *Id.*

By allowing this flagrant GAAP violation, E&Y violated Generally Accepted Auditing Standards ("GAAS"). As a result of E&Y's reckless conduct, the financials disseminated to the public during the Class Period were materially misleading and/or false.

E&Y would have this Court ignore these glaring GAAP and GAAS violations and

1 insist that Plaintiffs plead specifics relating to E&Y's audit that are proprietary to E&Y or
2 confidentially maintained by E&Y and Medicis. Indeed, E&Y argues that they are
3 afforded a privileged position under the securities laws, which requires an even higher
4 pleading standard than that applicable to Medicis and the Individual Defendants. Recent
5 case law however has firmly laid to rest any notion of privilege under the law. As the
6 court in *Countrywide* explained:

7 Some courts have given outside auditors as a class remarkable deference in
8 part because some courts think outside auditors lack "any rational economic
9 incentive to participate in its client's fraud." *Reiger v. Price Waterhouse*
10 *Coopers, LLP*, 117 F. Supp. 2d 1003 (S.D. Cal. 2000), *aff'd sub. nom.*
11 *DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385 (9th Cir.
12 2002). The Court finds this supposition suspect, at best. Auditors are hired
13 and retained by insiders. A few top auditing firms compete for high-profile
14 clients such as Countrywide. Therefore, they have strong structural
15 incentives to yield to management on close questions. More to the point,
16 *Tellabs* and *South Ferry* put to rest the misguided idea that courts should
17 create categorical rules and presumptions for different kinds of actors and
18 statements.

19 *Countrywide*, at 1197.

20 After *Tellabs* and *South Ferry*, there is no basis to ascribe any heightened status
21 for auditors. The majority of cases cited by E&Y in support of their claim for a more
22 stringent standard are pre-*Tellabs* decisions. The Supreme Court put such arguments to
23 rest when it stated the standard for alleging *scienter* under Section 10(b) of the Exchange
24 Act. It did not state that the standard was only for individuals and corporations, nor did it
25 carve out any higher standard for auditors. Regardless of whether the defendant is an
26 auditor or a CEO, if a plaintiff alleges facts that support an inference of *scienter* that are
27 "cogent and at least as compelling as any opposing inference of nonfraudulent intent,"
28 then *scienter* has been adequately pled. *Tellabs*, 551 U.S. at 315. Here, there are a host
of allegations that E&Y ignored the clear and obvious application of SFAS 48. In so
doing, one can conclude only that its auditing of revenue for returns amounted to *no audit*
at all. *DSAM*, 288 F.3d at 390.

Turning a blind eye to the obvious at a minimum supports the allegation that E&Y acted recklessly. *See Chill v. Gen. Elec. Co.*, 101 F.3d 263, 269 (2d Cir. 1996) (holding that “an egregious refusal to see the obvious” supports an inference of *scienter*). When combined with the facts that Medicis was channel stuffing, that Medicis deliberately misinformed investors regarding its reserve accounting, and that E&Y had raised questions regarding the accounting implications of expired products early in the Class Period, one can easily infer that E&Y’s actions were knowingly deliberate. The inference that E&Y acted recklessly or intentionally is at least as compelling as the possibility that E&Y innocently misapplied SFAS 48.

E. The Amended Complaint Adequately Alleges Section 20(a) Liability

The Amended Complaint alleges that the Company and Individual Defendants committed a primary violation of Section 10(b) of the Exchange Act, and that the Individual Defendants acted as controlling persons of Medicis within the meaning of Section 20(a) of the Exchange Act by virtue of their positions and their power to control public statements about Medicis. The defendants had the power and ability to control the actions of Medicis and its employees, and Medicis controlled the defendants and its other officers and employees. By reason of such conduct, defendants are liable pursuant to Section 20(a). Here the first element is satisfied because, as discussed above, the Amended Complaint has adequately alleged a primary violation by the defendants under Section 10(b) and Rule 10b-5 promulgated thereunder.

CONCLUSION

For the reasons stated herein, Plaintiffs respectfully request this Court deny defendants’ motion to dismiss.

Respectfully submitted this 22nd day of March, 2010.

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CERTIFICATE OF SERVICE

I hereby certify that on March 22, 2010 electronically transmitted the attached document to the Clerk's Office using the CM/ECF System for filing and transmittal of a Notice of Electronic Filing to the following CM/ECF registrants:

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